

AMENDED IN SENATE JUNE 17, 2003

AMENDED IN SENATE APRIL 24, 2003

SENATE BILL

No. 1067

Introduced by Senator Speier

February 27, 2003

An act to add ~~Section 25115 to~~ *amend Section 25110* of the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

SB 1067, as amended, Speier. Corporation taxes: water's-edge election: *inverted corporations*.

The Corporation Tax Law imposes taxes measured by income and, in the case of a business with income derived from or attributable to sources both within and without this state, apportions the income between this state and other states and foreign countries in accordance with a specified 4-factor formula based on the property, payroll, and sales within and without this state, except as otherwise provided. That law allows corporations to elect whether their income is determined on a "water's-edge" basis or on a worldwide unitary basis. The election to report income on a water's-edge basis is made by contract between the taxpayer and the Franchise Tax Board. In general, a corporation that makes a water's-edge election is subject to tax on income only from sources within the United States.

This bill would ~~prohibit any~~ *require a corporation that makes a water's-edge election to include the income and apportionment factors of its affiliated* foreign incorporated entity that is treated as an inverted

domestic corporation, as specified, from making a water's-edge election, as provided defined.

This bill would result in a change in state taxes for the purpose of increasing state revenues within the meaning of Section 3 of Article XII A of the California Constitution, and thus would require for passage the approval of $\frac{2}{3}$ of the membership of each house of the Legislature.

This bill would take effect immediately as a tax levy.

Vote: $\frac{2}{3}$. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

- 1 ~~SECTION 1. Section 25115 is added to the Revenue and~~
2 ~~SECTION 1. The Legislature finds and declares all of the~~
3 ~~following:~~
4 ~~(a) A number of publicly traded United States domiciled~~
5 ~~corporations that are subject to a water's-edge election are~~
6 ~~becoming "inverted domestic corporations" in order to avoid~~
7 ~~their fare share of California taxation.~~
8 ~~(b) An "inverted domestic corporation" is a corporation that~~
9 ~~changes the country of its legal domicile to a domicile located~~
10 ~~outside of the United States. One of the results of this change may~~
11 ~~be tax reporting advantages. In substance, these transactions are~~
12 ~~essentially "paper transactions" that have no significant effect on~~
13 ~~the business operations of the taxpayers involved. Typically, the~~
14 ~~inverted corporation has no substantial business presence in the~~
15 ~~country of its new domicile.~~
16 ~~(c) Under the water's-edge election rules, a domestic~~
17 ~~corporation includes all of its worldwide income in the~~
18 ~~water's-edge group, while much of a foreign corporation's income~~
19 ~~is excluded from income of the group. If the foreign status of an~~
20 ~~inverted domestic corporation is respected, the inverted domestic~~
21 ~~corporation can remove a large portion of its worldwide income~~
22 ~~from the California tax base of the water's-edge group, without~~
23 ~~changing any of its operations in any material respect, and~~
24 ~~therefore, significantly reduce the net income on which~~
25 ~~California's share of corporate income is calculated and taxed.~~
26 ~~(d) Treating an inverted domestic corporation as if it retained~~
27 ~~its status as a United States domiciled corporation for purposes of~~

1 *a water's-edge election would stem the loss of corporate tax*
2 *revenue.*

3 *SEC. 2. Section 25110 of the Revenue and Taxation Code is*
4 *amended to read:*

5 25110. (a) Notwithstanding Section 25101, a qualified
6 taxpayer, as defined in paragraph (2) of subdivision (b), that is
7 subject to the tax imposed under this part, may elect to determine
8 its income derived from or attributable to sources within this state
9 pursuant to a water's-edge election in accordance with the
10 provisions of this part, as modified by this article. A taxpayer that
11 makes a water's-edge election shall take into account the income
12 and apportionment factors of the following affiliated entities only:

13 (1) Domestic international sales corporations, as described in
14 Sections 991 to 994, inclusive, of the Internal Revenue Code and
15 foreign sales corporations as described in Sections 921 to 927,
16 inclusive, of the Internal Revenue Code.

17 (2) Any corporation (other than a bank), regardless of the place
18 where it is incorporated if the average of its property, payroll, and
19 sales factors within the United States is 20 percent or more.

20 (3) (A) Corporations that are incorporated in the United States,
21 excluding corporations making an election pursuant to Sections
22 931 to 936, inclusive, of the Internal Revenue Code, of which more
23 than 50 percent of their voting stock is owned or controlled directly
24 or indirectly by the same interests.

25 (B) *An inverted domestic corporation.*

26 (4) A corporation that is not described in paragraphs (1) to (3),
27 inclusive, or paragraph (5), but only to the extent of its income
28 derived from or attributable to sources within the United States and
29 its factors assignable to a location within the United States in
30 accordance with paragraph (3) of subdivision (b). Income of that
31 corporation derived from or attributable to sources within the
32 United States as determined by federal income tax laws shall be
33 limited to and determined from the books of account maintained
34 by the corporation with respect to its activities conducted within
35 the United States.

36 (5) Export trade corporations, as described in Sections 970 to
37 972, inclusive, of the Internal Revenue Code.

38 (6) Any affiliated corporation which is a "controlled foreign
39 corporation," as defined in Section 957 of the Internal Revenue
40 Code, if all or part of the income of that affiliate is defined in

1 Section 952 of Subpart F of the Internal Revenue Code (“Subpart
2 F income”). The income and apportionment factors of any affiliate
3 to be included under this paragraph shall be determined by
4 multiplying the income and apportionment factors of that affiliate
5 without application of this paragraph by a fraction (not to exceed
6 one), the numerator of which is the “Subpart F income” of that
7 corporation for that taxable year and the denominator of which is
8 the “earnings and profits” of that corporation for that taxable year,
9 as defined in Section 964 of the Internal Revenue Code.

10 (7) (A) The income and factors of the above-enumerated
11 corporations shall be taken into account only if the income and
12 factors would have been taken into account under Section 25101
13 if this section had not been enacted.

14 (B) The income and factors of a corporation that is not
15 described in paragraphs (1) to (3), inclusive, and paragraph (5) and
16 that is an electing taxpayer under this subdivision shall be taken
17 into account in determining its income only to the extent set forth
18 in paragraph (4).

19 (b) For purposes of this article and Section 24411:

20 (1) (A) An “affiliated corporation” means a corporation that
21 is a member of a commonly controlled group as defined in Section
22 25105.

23 (B) An “inverted domestic corporation” means a foreign
24 incorporated entity, as defined in clause (iii) of subparagraph (C),
25 if all of the following apply:

26 (i) Either subclause (I) or (II) applies:

27 (I) The foreign incorporated entity acquires, directly or
28 indirectly, substantially all of the properties held, directly or
29 indirectly, by a domestic corporation or substantially all of the
30 properties constituting a trade or business of a domestic
31 partnership or a related foreign partnership, and immediately
32 after the acquisition, either:

33 (aa) In the case of a domestic corporation, more than 50
34 percent of the stock, by vote or value, of the foreign incorporated
35 entity is held by former shareholders of the domestic corporation
36 by reason of holding stock in the domestic corporation.

37 (ab) In the case of a domestic partnership, more than 50 percent
38 of the stock, by vote or value, of the foreign incorporated entity is
39 held by former partners of the domestic partnership or related



1 *foreign partnership by reason of holding a capital or profits*
2 *interest in the domestic partnership or related foreign partnership.*

3 *(II) The foreign incorporated entity acquires, directly or*
4 *indirectly, substantially all of the properties held, directly or*
5 *indirectly, by a domestic corporation or substantially all of the*
6 *properties constituting a trade or business of a domestic*
7 *partnership or a related foreign partnership, and more than 50*
8 *percent of the stock, by vote or value, of the foreign incorporated*
9 *entity is held by domestic shareholders.*

10 *(ii) Immediately after the acquisition described in clause (i),*
11 *the properties acquired constitute at least 80 percent of the assets*
12 *of the foreign incorporated entity.*

13 *(C) (i) In applying subparagraph (B), the following rules*
14 *apply:*

15 *(I) There shall not be taken into account, in determining*
16 *ownership for purposes of subclause (I) of clause (i) of*
17 *subparagraph (B), either of the following:*

18 *(aa) Stock held by members of the expanded affiliated group*
19 *that includes the foreign incorporated entity.*

20 *(ab) Stock of that foreign incorporated entity that is sold in a*
21 *public offering related to the acquisition described in*
22 *subparagraph (B).*

23 *(II) If a foreign incorporated entity acquires, directly or*
24 *indirectly, substantially all of the property of a domestic*
25 *corporation or partnership during a four-year period and the*
26 *ownership requirements of clause (i) of subparagraph (B) are met*
27 *within two years from the date of that acquisition, then that*
28 *acquisition shall be treated as having been made pursuant to a*
29 *plan.*

30 *(III) The transfer of property or liabilities, including by*
31 *contribution or distribution shall be disregarded if the transfers*
32 *are part of a plan, a principal purpose of which is to avoid the*
33 *purposes of this section.*

34 *(IV) For purposes of applying subparagraph (B) to the*
35 *acquisition of a domestic partnership, all domestic partnerships*
36 *that are under common control within the meaning of Section 482*
37 *of the Internal Revenue Code shall, except as otherwise provided*
38 *in regulations prescribed by the Franchise Tax Board, be treated*
39 *as a partnership.*

(V) *The Franchise Tax Board may prescribe those regulations as may be necessary to do both of the following:*

(aa) *Treat warrants, options, contracts to acquire stock, convertible debt instruments, and other similar interest or intangibles as stock.*

(ab) *Treat stock as not stock.*

(ii) *Notwithstanding subparagraph (A), for purposes of subparagraph (B) the term “expanded affiliated group” means an affiliated group as defined in Section 1504(a) of the Internal Revenue Code, without regard to Section 1504(b)(3) of the Internal Revenue Code, except that Section 1504 of the Internal Revenue Code shall be applied by substituting “more than 50 percent” for “at least 80 percent” each place it appears.*

(iii) *The term “foreign incorporated entity” means any entity that is treated as a foreign corporation for purposes of the Internal Revenue Code.*

(iv) (I) *Except as provided in subclause (II), the terms “person,” “domestic,” and “foreign” have the meanings given those terms by paragraphs (1), (4), and (5), respectively, of Section 7701(a) of the Internal Revenue Code.*

(II) *For purposes of this article and the application of provisions of the Internal Revenue Code applicable for purposes of this article, including Subpart F of the Internal Revenue Code, a foreign incorporated entity that is an inverted domestic corporation shall be treated as a domestic corporation.*

(v) *For purposes of this section, indirect acquisition of property includes the acquisition of stock of the owner of that property.*

(2) A “qualified taxpayer” means a corporation which does both of the following:

(A) Files with the state tax return on which the water’s-edge election is made a consent to the taking of depositions at the time and place most reasonably convenient to all parties from key domestic corporate individuals and to the acceptance of subpoenas duces tecum requiring reasonable production of documents to the Franchise Tax Board as provided in Section 19504 or by the State Board of Equalization as provided in Title 18, California Code of Regulations, Section 5005, or by the courts of this state as provided in Chapter 2 (commencing with Section 1985) of Title 3 of Part 4 of, and Section 2025 of, the Code of Civil Procedure. The consent relates to issues of jurisdiction and service and does not waive any

defenses a taxpayer may otherwise have. The consent shall remain in effect so long as the water's-edge election is in effect and shall be limited to providing that information necessary to review or to adjust income or deductions in a manner authorized under Sections 482, 861, Subpart F of Part III of Subchapter N, or similar provisions of the Internal Revenue Code, together with the regulations adopted pursuant to those provisions, and for the conduct of an investigation with respect to any unitary business in which the taxpayer may be involved.

(B) Agrees that for purposes of this article, dividends received by any corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) from either of the following are functionally related dividends and shall be presumed to be business income:

(i) A corporation of which more than 50 percent of the voting stock is owned, directly or indirectly, by members of the unitary group and which is engaged in the same general line of business.

(ii) Any corporation that is either a significant source of supply for the unitary business or a significant purchaser of the output of the unitary business, or that sells a significant part of its output or obtains a significant part of its raw materials or input from the unitary business. "Significant," as used in this subparagraph, means an amount of 15 percent or more of either input or output.

All other dividends shall be classified as business or nonbusiness income without regard to this subparagraph.

(3) The definitions and locations of property, payroll, and sales shall be determined under the laws and regulations that set forth the apportionment formulas used by the individual states to assign net income subject to taxes on or measured by net income in that state. If a state does not impose a tax on or measured by net income or does not have laws or regulations with respect to the assignment of property, payroll, and sales, the laws and regulations provided in Article 2 (commencing with Section 25120) shall apply.

Sales shall be considered to be made to a state only if the corporation making the sale may otherwise be subject to a tax on or measured by net income under the Constitution or laws of the United States, and shall not include sales made to a corporation whose income and apportionment factors are taken into account pursuant to subdivision (a) in determining the amount of income

1 of the taxpayer derived from or attributable to sources within this
2 state.

3 (4) “The United States” means the 50 states of the United
4 States and the District of Columbia.

5 (c) All references in this part to income determined pursuant to
6 Section 25101 shall also mean income determined pursuant to this
7 section.

8 (d) *The amendments made to this section by the act adding this*
9 *subdivision apply as follows:*

10 (1) *To a taxpayer that is required to file on a water’s-edge basis*
11 *in its first taxable year beginning on or after January 1, 2003,*
12 *pursuant to a water’s-edge election in accordance with the*
13 *provisions of this part, as modified by this article, made on or after*
14 *January 1, 2003.*

15 (2) *To a taxpayer that is required to file on a water’s-edge basis*
16 *pursuant to a water’s-edge election in accordance with the*
17 *provisions of this part, as modified by this article, made in a year*
18 *prior to January 1, 2003, under Section 25111, in its first taxable*
19 *year beginning on or after January 1 of the year immediately*
20 *succeeding the expiration of the term of the water’s-edge contract*
21 *in effect on January 1, 2003.*

22 ~~Taxation Code, to read:~~

23 ~~25115. (a) Any foreign incorporated entity that is treated as~~
24 ~~an inverted domestic corporation under subdivision (b) may not~~
25 ~~make a water’s-edge election under this article.~~

26 ~~(b) For purposes of this section, a foreign incorporated entity~~
27 ~~shall be treated as an inverted domestic corporation if, pursuant to~~
28 ~~a plan (or a series of related transactions), all of the following~~
29 ~~apply:~~

30 ~~(1) The entity completes on or after January 1, 2003, the direct~~
31 ~~or indirect acquisition of substantially all of the properties held~~
32 ~~directly or indirectly by a domestic corporation or substantially all~~
33 ~~of the properties constituting a trade or business of a domestic~~
34 ~~partnership.~~

35 ~~(2) After the acquisition described in paragraph (1), at least 80~~
36 ~~percent of the stock (by vote or value) of the entity is held by either~~
37 ~~of the following:~~

38 ~~(A) In the case of an acquisition with respect to a domestic~~
39 ~~corporation, by former shareholders of the domestic corporation~~
40 ~~by reason of holding stock in the domestic corporation.~~

1 ~~(B) In the case of an acquisition with respect to a domestic~~
2 ~~partnership, by former partners of the domestic partnership by~~
3 ~~reason of holding a capital or profits interest in the domestic~~
4 ~~partnership.~~

5 ~~(3) The expanded affiliated group that, after the acquisition~~
6 ~~described in paragraph (1), includes the acquired entity does not~~
7 ~~have substantial business activities in the foreign country in which,~~
8 ~~or under the law of which, the entity is created or organized when~~
9 ~~compared to the total business activities of that expanded affiliated~~
10 ~~group.~~

11 ~~(c) (1) In applying subdivision (b), the following rules apply:~~

12 ~~(A) There shall not be taken into account in determining~~
13 ~~ownership, for purposes of paragraph (2) of subdivision (b), either~~
14 ~~of the following:~~

15 ~~(i) Stock held by members of the expanded affiliated group that~~
16 ~~includes the foreign incorporated entity.~~

17 ~~(ii) Stock of that entity that is sold in a public offering related~~
18 ~~to the acquisition described in paragraph (1) of subdivision (b).~~

19 ~~(B) If a foreign incorporated entity acquires, directly or~~
20 ~~indirectly, substantially all of the properties of a domestic~~
21 ~~corporation or partnership during the four year period beginning~~
22 ~~on January 1, 2003, and the ownership requirements of paragraph~~
23 ~~(2) of subdivision (b) are met within two years from the date of that~~
24 ~~acquisition, then, that acquisition shall be treated as having been~~
25 ~~made pursuant to a plan.~~

26 ~~(C) The transfer of properties or liabilities (including by~~
27 ~~contribution or distribution) shall be disregarded if the transfers~~
28 ~~are part of a plan, a principal purpose of which is to avoid the~~
29 ~~purposes of this section.~~

30 ~~(D) For purposes of applying subdivision (b) to the acquisition~~
31 ~~of a domestic partnership, all domestic partnerships that are under~~
32 ~~common control (within the meaning of Section 482 of the Internal~~
33 ~~Revenue Code) shall, except as otherwise provided in regulation,~~
34 ~~be treated as a partnership.~~

35 ~~(E) The franchise shall prescribe those regulations as may be~~
36 ~~necessary to do both of the following:~~

37 ~~(i) Treat warrants, options, contracts to acquire stock,~~
38 ~~convertible debt instruments, and other similar interest as stock.~~

39 ~~(ii) Treat stock as not stock.~~

1 ~~(2) The term “expanded affiliated group” means an affiliated~~
2 ~~group as defined in Section 1504(a) of the Internal Revenue Code~~
3 ~~(without regard to Section 1504(b) of that code), except that~~
4 ~~Section 1504 of that code shall be applied by substituting more~~
5 ~~than 50 percent for “at least 80 percent” each place it appears.~~

6 ~~(3) The term “foreign incorporated entity” means any entity~~
7 ~~that is, or but for subdivision (b) would be, treated as a foreign~~
8 ~~corporation for purposes of the Internal Revenue Code.~~

9 ~~(4) The terms “person,” “domestic,” and “foreign” have the~~
10 ~~meanings given those terms by paragraphs (1), (4), and (5) of~~
11 ~~Section 7701(a) of the Internal Revenue Code, respectively.~~

12 ~~(d) The Franchise Tax Board shall waive subdivision (a) with~~
13 ~~respect to any specific contract if the Franchise Tax Board~~
14 ~~determines that the waiver is required in the interest of homeland~~
15 ~~security, or to prevent the loss of any jobs in California or prevent~~
16 ~~the state from incurring any additional costs that otherwise would~~
17 ~~not occur.~~

18 ~~(e) This section applies only to water’s-edge elections,~~
19 ~~including extensions, made on or after January 1, 2003, and does~~
20 ~~not affect any contracts in existence prior to that date.~~

21 ~~SEC. 2.—~~

22 ~~SEC. 3.~~ This act provides for a tax levy within the meaning
23 of Article IV of the Constitution and shall go into immediate
24 effect.